INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

May 4, 2000

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Medical Care Deductions

This Field Service Advice responds to your memorandum dated January 31, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =
B =
Date 1 =
Date 2 =

ISSUE:

Whether an accrual basis taxpayer may deduct at year end, the amount of its claim reserve account consisting of an estimate of its liability for services rendered to enrollees prior to the end of the year, but for which claims have not been filed.

CONCLUSION:

A may not accrue medical expenses, even if preauthorized, until the year the services are performed.

FACTS:

A is a wholly owned subsidiary of B, a specialty healthcare company. A is an accrual basis taxpayer, and the taxable years at issue end on Date 1 and Date 2.

A engages in specialty network management. Through its subsidiaries, it develops and

manages independent physician networks that provide specialty healthcare services to managed care organizations and other entities. It primarily services HMO's and insurance companies (payers) that coordinate healthcare for a patient population (enrollees). A and its subsidiaries have organized networks in various specialties, such as cardiology, orthopedics, obstetrics/gynecology, ENT, and dialysis/nephrology. A is not licensed to do business as an insurance company, HMO or third party administrator.

A negotiates payer contracts to provide specialty healthcare according to the payer's plan and to perform the actual services. The network itself will provide practice management and claims administration services as specified under the contract. A medical director affiliated with the network and/or a plan administrator generally oversees such services.

Payer contracts are negotiated on a capitated or at risk basis; that is, compensation is calculated based on the number of the enrollees, regardless of the amount of care actually required. Services are provided to the payer's members in accordance with the payer's plan, and the network is responsible to pay all expenses related to the delivery of such services including physician costs.

Services provided by affiliated physicians are preauthorized, usually by the member's primary care physician or a medical director affiliated with either the plan or the network. Under the terms of the standard payer contract, the physician may receive payment only for preauthorized services, may seek payment for services solely from A and must submit to A a claim form within 60 days after providing services.

Notwithstanding the 60 day rule, A has paid claims that were filed in excess of 60 days after the date of service, and in some instances processed claims filed over 8 months after the provision of services.

A's books and records reflect a claim reserves account consisting of claims that have been received but not yet paid (claims in process), and an estimate of claims incurred but not yet received (IBNR claims). The IBNR serves to supplement the adequacy of the claim reserves. The adequacy of the account is based on historical trends and a medical loss ratio (MLR) to determine the amount of capitated revenue that will likely be required to pay claims. To determine the IBNR, A uses historical lag factors between the date a claim is incurred and the date it is processed. The factor represents an estimate of claims outstanding for any given period. This factor is then applied to claims paid for a period to determine the amount that is expected to be paid. The difference between the amount expected to be paid and the amount paid for the period becomes the IBNR reserve. Based on samples reviewed by Exam, the IBNR approximated 35% of A's total claim reserves account.

Provider claims are received and processed in monthly and semi-monthly batches, and the IBNR is reduced by the amount of claims paid.

A conducts a lookback review of claims paid subsequent to year end to analyze its IBNR

adequacy. Based on these reviews, on average 96% or more of the IBNR for any given period is paid within eight months of the date of service. For the two taxable years in issue, the amount of claims paid exceeded the IBNR remaining at the respective year end periods.

A consistently treats all of the IBNR claims (estimated claims) as liabilities that have been incurred in the tax years at issue.

LAW:

Under an accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2). For purposes of determining whether an accrual basis taxpayer can treat the amount of any liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability. Treas. Reg. § 1.461-4(a). Further, if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property are provided. Treas. Reg. § 1.461-4(d)(2)(i).

Pursuant to Treas. Reg. § 1.461-5(a) a taxpayer using an accrual method of accounting may adopt the recurring item exception for one or more types of recurring items. Under the recurring item exception, a liability is treated as incurred for a taxable year if (i) as of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy; (ii) economic performance with respect to the liability occurs on or before the earlier of–(A) the date the taxpayer files a timely return; or (B) the 15th day of the 9th calendar month after the close of the taxable year; (iii) the liability is recurring in nature and (iv) either (A) the amount of the liability is not material; or (B) the accrual of the liability for that taxable year results in a better match of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs.

United States v. General Dynamics Corp., 481 U.S. 239 (1987) involved the submission of health insurance claims by employees to General Dynamic's self-insured health insurance plan. Under the terms of the contract with its employees, General Dynamics had no liability to reimburse medical expenses until a claim was submitted. While the Court did not challenge the Claims Court's factual conclusion that the processing of the claims was "routine", "clerical", and "ministerial" in nature, it held that a claim must be submitted in order for the liability to reimburse employees for medical expenses to be fixed under the all events test. This conclusion appears to be based primarily on a concern that employees often fail to file claims with their employer for various reasons, and thus an employee's receipt of covered medical services was not sufficient to fix General Dynamic's liability. The Court stated that the filing of the claim "is not a mere technicality." The Court also noted that the failure to file a claim was not the type of "extremely remote and speculative possibility" that in United States v. Hughes Properties, 476

U.S. 593 (1986) did not render an otherwise fixed liability contingent.

Furthermore, General Dynamics had attempted to deduct the reserve amount for claims incurred but not reported (IBNR) that had been on the books of its insurance companies. In disallowing the deduction, the Supreme Court stated that if the "all events" test permitted the deduction of an estimated reserve representing claims that were actuarially likely but not yet reported, Congress would not have found it necessary to enact an explicit provision allowing insurance companies to do so. The Court may have been concerned that treating the provision of medical services as the last event necessary to fix the liability would have effectively allowed the deduction of an IBNR reserve since, once "all events" have occurred, a taxpayer may estimate the amount of the liability. While regulations permit a taxpayer to reasonably estimate the amount of its liability, it may not estimate the fact that the liability was fixed during the year, which is the effect of taking an IBNR reserve.

Court cases and Service rulings have held that, in certain circumstances, even where the conditions of payment required that the taxpayer submit documentation or a claim before payment would be made, these were purely ministerial acts that did not affect the right to payment. The Supreme Court in General Dynamics, though requiring the submission of claims, viewed the processing of claims as ministerial. In some cases, though, the all events test is met when substantive performance occurs, notwithstanding a requirement for documentation deemed to be ministerial.

For example, in Continental Tie and Lumber Co. v. United States, 286 U.S. 290 (1932), the Transportation Act provided for awards to railroads that competed for traffic or connected with a railroad under federal control, and no amount would be paid until the I.C.C. made an award, nor was there any proceeding available to compel an allowance, but the I.C.C. function was held to be ministerial, to ascertain the facts and make comparisons. Thus, taxpayer accrued income prior to the award. Likewise, in Cloverleaf Creamery Co., Inc. v. Davis, 97 F. Supp. 121 (N.D. Al. 1951), the Defense Department regulations granted subsidiary payments to manufacturers of processed butter that complied with certain requirements. The submission of a claim and its approval by the Defense Supplies Corporation were purely ministerial acts which did not affect or delay the right to payment. See also Rev. Rul. 74-432, 1974-2 C.B. 147 (where stock brokerage house enters into contracts to buy or sell securities at the request of investors, taxpayer accrues commission income at the time of trade and not 5 days later when sales are recorded and the securities are delivered, because all actions after the trade are of a ministerial nature and are merely in confirmation of the trade).

In contrast, where performance requirements are complex and subject to problems of interpretation, accrual may be delayed until approval. See H.J. Heinz Co. v. Granger, 147 F.Supp. 664 (W.D. Pa. 1956) (no accrual until approval since taxpayer was required to comply with numerous governmental orders and regulations to which the contracts were subject; problems of interpretation, changing regulations, the magnitude of taxpayer's operation, and inexperienced and uninformed employees made violations possible; real differences could arise as to whether there had been violations; the governmental authority had reserved to itself a considerable amount of discretion with respect to the determination of when the conditions

requisite had been fulfilled).

ANALYSIS:

The proposed deduction is for services that have been preauthorized. Under these facts, the last event necessary to fix the fact of the liability is the performance of preauthorized medical services. No matter how statistically certain it is that the preapproved medical services will be delivered, no liability arises unless the services are rendered. General Dynamics, 481 U.S. at 243-44 ("[A] taxpayer may not deduct a liability that is contingent....Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year.").

Pursuant to section 461(h)(2)(A), economic performance occurs as preauthorized services are provided by physicians to enrollees, Treas. Reg. § 1.461-4(d)(2) (services or property provided to the taxpayer), and, therefore, the deduction is not accruable until services had been provided.

You state that A has properly adopted the recurring item exception. We believe, though, that A is not entitled to use the recurring item exception. Although preauthorization has occurred, that event does not fix the fact of the liability. The liability is fixed and economic performance occurs upon the happening of the same event–the delivery of medical services. Therefore, under these facts, A does not qualify to use the recurring item exception.

With respect to whether the deduction is estimated with reasonable accuracy, the estimate may not be made until the services have been provided. Thus, of course, in this case, A has been prematurely estimating its liability. Nevertheless, we do wish to discuss the process of making a reasonable estimate in general, because in addition to taking a premature deduction, A was using an incorrect methodology for estimating its liability.

The facts indicate that preauthorized services are compensated under a fixed fee schedule, and that the amount of the estimated liability is based on actuarial data. In another factual context this procedure could meet the second prong of the all events test as long as the estimate is not of future expenses derived from statistical projections based on historical data, rather than estimates of the costs of the preauthorized services. For example, an improper method of estimating a liability would be based solely on past experience rather than estimating specific liabilities for preauthorized services. A fixed liability may be estimated, but it is improper to estimate a probable liability based on past experience, which actually constitutes estimating the fact of liability–that is, predicting the actuarial likelihood of certain claims of a certain monetary cost.

Also historical data may not be used in making an estimate of the liability. You state that the amount of A's reserve is calculated based on historical trends and historical lag factors between the date a claim is incurred and the date it is processed. Second prong estimates which rely solely on historical or actuarial data without reference to the fixed liability event is not permitted. Also, in this case, A's use of a reserve is an improper deduction under tax accounting

rules. In General Dynamics, the Court noted that based on actuarial data, taxpayer may have been able to estimate how many claims would be filed for the year end quarter at issue, but "that alone does not justify a deduction." 481 U.S. at 245. Furthermore, the Court stated at a "reserve based on the proposition that a particular set of events is likely to occur in the future may be an appropriate conservative accounting measure, but does not warrant a tax deduction." General Dynamics, 481 U.S. at 246. Deducting the amount of a reserve which is based on historical trends is not permitted. The difference is between making an estimate based on past trends versus making an estimate based on the actual events of preauthorized services. Once the fact of liability has been established, actuarial data may be used to make a reasonably accurate estimate of the liability, using the preauthorized services as the basis for deriving the estimate.

In summary, it appears that A may not use the recurring item exception, and it is important to determine that A is not basing a deduction on actuarial data and estimates which do not factually relate to specific preauthorized services.

We also note that the necessity for filing a claim does not delay the proper time for accrual because the claims filing and review process is ministerial. Note, for example, that A pays claims which are filed long past its prescribed cutoff date. See Continental Tie, supra, and Cloverleaf Creamery, supra.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

DEBORAH A. BUTLER

By: _____